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IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

DEPARTMENT OF REVENUE,
STATE OF ILLINOIS, et al.,

Petitioners,

v.

CONTINENTAL ILLINOIS NATIONAL BANK
AND TRUST COMPANY OF CHICAGO, et al.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
SUPREME COURT OF ILLINOIS

BRIEF FOR RESPONDENTS IN OPPOSITION

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QUESTIONS PRESENTED FOR REVIEW

Respondents believe that in addition to the question on the merits addressed by the Petition, the following jurisdictional question is presented:

> Whether this Court has jurisdiction to review the decision of the Supreme Court of Illinois where that Court rejected the Petitioners' position based in part upon that Court's interpretation of the state statute, the Illinois Income Tax Act.

Respondents believe that fairly stated, the question on the merits should be stated as follows:

> Does 31 U.S.C. § 742 permit interest income from United States obligations to be included in the numerator and denominator of the apportionment fraction used by a financial organization under the Illinois Income Tax Act.

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JURISDICTION

For the reason stated in Part I below of Reasons for Denying the Petition, Respondents believe that the Court lacks jurisdiction to review the decision of the Supreme Court of Illinois.

SUMMARY OF ARGUMENT

Respondents believe that this Court is without jurisdiction to review the decision of the Supreme Court of Illinois for the reason that such decision rests upon an adequate and indepen-

dent state ground. That Court's opinion clearly indicates that it interpreted the state statute, the Illinois Income Tax Act, in rejecting the Petitioners' position.

The decision of the Supreme Court of Illinois is also based upon, and is clearly consistent with, this Court's interpretation of 31 U.S.C. § 742 and with the decisions of the Supreme Courts of Rhode Island and Montana. The Department's attempt to create a conflict between the decision of the Supreme Court of Georgia in *Bartow County Bank* v. *Bartow County Board of Tax Assessors, et al.*, 251 Ga. 831, 312 S.E.2d 102 (1984), *prob. juris. noted sub nom. First National Bank of Atlanta, etc.* v. *Bartow County Board of Tax Assessors,* No. 83-1620, 104 S.Ct. 2654 (1984), is misguided. The two cases involve very different facts and legal issues.

REASONS FOR DENYING THE PETITION

I. THIS COURT LACKS JURISDICTION BECAUSE THE DECISION OF THE SUPREME COURT OF ILLINOIS RESTS UPON AN ADEQUATE AND INDEPENDENT STATE GROUND.

Continental Illinois National Bank and Trust Company of Chicago, et al. ("Continental Bank")[1] maintains that this Court is without jurisdiction to review the decision of the Supreme

[1] The parent company of Continental Illinois National Bank and Trust Company of Chicago is Continental Illinois Corporation. The subsidiaries and affiliates (other than wholly owned subsidiaries and affiliates) of Continental Illinois National Bank and Trust Company of Chicago are Continental Illinois Leasing S.A. (Spain), Commercial Continental Limited (Australia), Compania Financiera Ecuatoriana de DeSarrollo S.A. (Ecuador), Malaysian International Merchant Bankers Berhad (Malaysia), Rizal Commercial Banking Corporation (Philippines), and NAL Merchant Bank Limited (Nigeria). It is expected that on or about September 26, 1984 Continental Illinois Holding Corporation will become the owner of all the then outstanding common stock of Continental Illinois Corporation.

Court of Illinois for the reason that such decision rests upon an adequate and independent state ground. The second to the last paragraph of the Supreme Court of Illinois' opinion indicates that the Court reached its conclusion in part on the basis of the Federal statute, 31 U.S.C. § 742. However, in the preceding paragraph of its opinion the Court clearly stated that its decision was firmly supported by its construction of the Illinois Income Tax Act. That paragraph of the Court's opinion reads:

> "Section 304(c) (3) of the Act (Ill. Rev. Stat. 1973, ch. 120, par. 3-304(c) (3)) instructs the taxpayers to include '[i]nterest and dividends received within this State' in the apportionment formula. The State maintains that the clear language of this provision mandates the inclusion of tax-exempt, as well as taxable, interest received within Illinois. We do not agree. 'The purpose of the apportionment formula is to confine the taxation of business income to that portion which is attributable to activities in Illinois.' (*Caterpillar Tractor Co.* v. *Lenckos* (1981), 84 Ill. 2d 102, 123, *appeal dismissed sub nom, Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.* (1983), ____ U.S. ____, 77 L. Ed. 2d 1402, 103 S. Ct. 3562.) It is illogical to assume that the General Assembly would devise a formula to measure taxable income which includes income that is clearly tax-exempt." 102 Ill. 2d at 224.

Continental Bank strongly argued in its brief and at oral argument in the Supreme Court of Illinois that including interest from United States obligations in the apportionment formula conflicts with the sound construction of the Illinois Income Tax Act. The paragraph quoted above shows that the Supreme Court of Illinois agreed with Continental Bank's interpretation of that act. The paragraph interprets the language of the Illinois Income Tax Act and cites one of the Supreme Court of Illinois' leading cases dealing with the purpose of apportionment under the act.

Furthermore, Continental Bank believes that the analysis provided in the above quoted paragraph overcomes the pre-

sumption set forth by this Court in *Michigan* v. *Long*, 103 S. Ct. 3469 (1983). The quoted paragraph makes it clear, from the face of the Supreme Court of Illinois' opinion, that the Court's decision is grounded on an interpretation of the Illinois Income Tax Act, separate and apart from the Federal statute.

II. THE DECISION OF THE SUPREME COURT OF ILLINOIS CORRECTLY APPLIES 31 U.S.C. § 742.

This case involves the apportionment fraction to be used by a financial organization under Section 3-304(c) of the Illinois Income Tax Act (Ill. Rev. Stat., 1973, ch. 120, par. 3-304(c)) in calculating the percentage of such financial organization's income which may be taxed by the State of Illinois. Section 3-304(c) provides in pertinent part:

> "(c) Financial organizations. Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business income from all sources. For the purposes of this subsection, the business income of a financial organization from sources within this State is the sum of:
>
> * * *
>
> "(3) Interest and dividends received within this State;
>
> * * *

In summary, the apportionment formula may be expressed as follows:

$$\frac{\text{Illinois gross receipts}}{\text{Gross receipts from everywhere}} \times \text{Business Income} \times 4\%^{2} = \text{Illinois income tax}$$

[2] The corporate tax rate during the taxable years in question was 4%. The rate was subsequently increased.

During the taxable years involved, 1973, 1974 and 1975, Continental Bank received in Illinois substantial amounts of interest on obligations of the United States Government. Continental Bank deducted this interest in computing its tax base pursuant to Section 2-203(b)(2)(F) of the Illinois Income Tax Act (Ill. Rev. Stat., 1973, ch. 120, par. 2-203(b)(2)(F)) which provides a deduction for "all amounts . . . which are exempt from taxation by [the State of Illinois] either by reason of its Constitution or by reason of the Constitution, treaties or statutes of the United States." The exclusion of such interest from the tax base is not in dispute.

Continental Bank also excluded the interest on such Federal obligations in calculating the numerator and denominator of its apportionment fraction on the grounds, in short summary, that to include such tax-exempt interest in the formula (i) conflicts with the sound construction of the Illinois Income Tax Act and (ii) expressly contravenes 31 U.S.C. § 742, and further, burdens the power of Congress to borrow money on the credit of the United States under Article I, Section 8, Clause 2 of the Constitution of the United States.

A. The Decision of the Supreme Court of Illinois Is Consistent with the Decision of this Court in *American Bank and Trust Co.* v. *Dallas County*.

The Supreme Court of Illinois correctly determined that the inclusion of tax-exempt interest on United States obligations in Continental Bank's apportionment fraction contravenes Section 742 of Title 31 of the United States Code (1976) which provides an exemption from state taxation of United States obligations and provides that such "exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or

indirectly, in the computation of the tax [subject to certain exceptions]".[3]

The Supreme Court of Illinois' decision is based upon and is completely consistent with this Court's interpretation of 31 U.S.C. § 742 as set forth in *American Bank and Trust Co.* v. *Dallas County,* 103 S. Ct. 3369 (1983). In that case, this Court stated,

> "The exemption for federal obligations provided by [31 U.S.C. § 742], as amended in 1959, is sweeping: with specific exceptions, it 'extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation* of the tax' (emphasis supplied). See *Memphis Bank & Trust Co.* v. *Gardner,* ____ U.S. ____, ____ 103 S. Ct. 692, 695, 74 L. Ed. 2d 562 (1983) (the statute

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[3] 31 U.S.C. § 742 was in effect during the taxable years in question here, 1973, 1974 and 1975. Pursuant to Public Law 97-258 (September 13, 1982), 31 U.S.C. § 742 was revised and recodified as 31 U.S.C. § 3124. The revision and recodification was enacted as part of legislation which had as its purpose "to restate in comprehensive form, without substantive change, certain general and permanent laws related to money and finance . . . ." H. R. Rep. No. 97-651, 97th Cong., 2nd Sess. (1982), *reprinted in* 1982 U.S. Code Cong. & Ad. News 1895. The congressional committee report which accompanied the legislation makes clear that no substantive change is made in stating:

"*Substantive change not made.*—As in other codifications undertaken to enact into positive law all titles of the United States Code, this bill makes no substantive change in the law. It is sometimes feared that mere changes in terminology and style will result in changes in substance or impair the precedent value of earlier judicial decisions and other interpretations. This fear might have some weight if this were the usual kind of amendatory legislation where it can be inferred that a change of language is intended to change substance. In a codification law, however, the courts uphold the contrary presumption: the law is intended to remain substantively unchanged. The following authorities affirm this principle: . . . ." H. R. Rep. No. 97-651 at 3, 1982 U.S. Code Cong. & Ad. News at 1897.

'establishes a broad exemption')." (emphasis original) 103 S. Ct. at 3374.

* * *

"Under the plain language of the 1959 amendment, however, the tax is barred regardless of its *form* if federal obligations must be considered, either directly or indirectly, in *computing* the tax.... In context, the word 'considered' means taken into account, or included in the accounting." (emphasis original) 103 S. Ct. at 3374.

It is clear, as the Supreme Court of Illinois concluded, that the inclusion of tax-exempt interest on United States obligations in Continental Bank's apportionment fraction results, at a minimum, in the indirect consideration of interest on Federal obligations in the computation of its Illinois income tax.

B. The Decision of the Supreme Court of Illinois Is Consistent with Decisions of the Supreme Courts of Rhode Island and Montana.

The decision of the Supreme Court of Illinois in this case is completely consistent with the decision of the Supreme Court of Rhode Island in *Federal Products Corp.* v. *Norberg,* 429 A.2d 447 (R.I., 1981). In the *Federal Products* case, the deficiency arose, in part, from the inclusion of interest derived from, and the proceeds from the sale of, tax-exempt United States government obligations in the apportionment formula used to measure the amount of the taxpayer's net income subject to tax by the State of Rhode Island. The Supreme Court of Rhode Island held the formula was invalid because it resulted in an indirect levy on tax-exempt Federal securities.

The Rhode Island Supreme Court set forth the basis for its decision in the following language:

"The fact that the administrator did not *directly* tax the proceeds and interest from the U.S. Treasury notes and bonds and common stock is not determinative, for it is clear that 31 U.S.C.A. § 742 prohibits an *indirect* tax on

> such items. Although the administrator contends that he included the proceeds from the sale of federal obligations and the interest merely as a measure to determine the corporate income tax due Rhode Island, he somehow overlooks the fact that the amount of the tax assessed was increased by more than $11,000 by the inclusion of the tax-exempt obligations in the measure of the tax. The only reasonable conclusion to draw is that this was an indirect tax upon federal securities, and thus, invalid." (emphasis original) 429 A.2d at 449.

The Department of Revenue, et al. (the "Department") argues that interest on Federal obligations is not being subjected to tax, but is included in the apportionment formula merely as a measure to determine the corporate income tax due to Illinois. This was precisely the argument that was made by the Rhode Island tax administrator. Thus, the Department's argument has not only been rejected by the Supreme Court of Illinois, but was expressly rejected by the Rhode Island Supreme Court as well.

In addition, in *First Federal Savings & Loan Association* v. *Department of Revenue,* 654 P.2d 496 (Mont., 1982), *cert. denied,* 103 S. Ct. 3128 (1983), the Supreme Court of Montana acknowledged the correctness of the Rhode Island Supreme Court's decision in *Federal Products* by summarizing the conclusions reached by the Rhode Island Supreme Court in the *Federal Products* case as support for its conclusion that the inclusion of interest income on exempt Federal obligations in the tax base for purposes of calculating the Montana Corporation License Tax was prohibited by 31 U.S.C. § 742.

III. THE DEPARTMENT'S ARGUMENT MISSTATES THE EFFECT OF THE ILLINOIS APPORTIONMENT FORMULA AND MISCHARACTERIZES THE DECISION OF THE SUPREME COURT OF ILLINOIS.

At pages 8-9 of its Petition, the Department makes several arguments with respect to why its position does not contravene

31 U.S.C. § 742. The Department's arguments lack substantive merit. First, the Department asserts that the apportionment formula merely distributes the tax base among the jurisdictions in which a business operates so that while the tax base increases or decreases relatively in the various jurisdictions, neither the total tax base nor the total amount of tax payable by the taxpayer should increase. The Department's assertion is unsupported and is based upon assumptions that cannot properly be made. First, it is based upon the incorrect assumption that all states in which a corporate taxpayer does business will impose an income tax. Nevada and Washington are two states that do not impose an income tax on corporations (see *CCH State Tax Reporter — Nevada,* Vol. 1 at 501 (1984); *CCH State Tax Reporter — Washington,* Vol. 1 (1984)). Second, it is based upon the incorrect assumption that all states that impose an income tax on corporate taxpayers will impose the tax at the same rates. In fact, current maximum state corporate income tax rates range from 2.35% in Michigan to 12% in Iowa and Minnesota (see *CCH State Tax Guide — All States,* 2d ed. at 1031-32 (1984)). Third, it is based upon the incorrect assumption that all states will adopt a uniform apportionment formula so that the total amount taxed by all the states will not exceed the income of the taxpayer which is not exempt under 31 U.S.C. § 742. However, a state that would lose revenue under the uniform approach urged by the Department may well choose to use the very approach urged by Continental Bank. Fourth, even if the Department *could* support its statements to the effect that the inclusion of interest on United States obligations in the apportionment formula should cause no net increase in tax liability for all jurisdictions in which a taxpayer does business, the Department's position, nonetheless, ignores the language of 31 U.S.C. § 742. That language requires that interest on United States obligations not "be *considered,* directly or indirectly, in the computation of the tax," regardless of whether there is an increase in tax liability.

The Department also argues that interest on United States obligations is not considered in the computation of the Illinois income tax because the apportionment formula represents a separate computation. This argument is wholly lacking in logic. As this Court stated in *American Bank and Trust Co.*, the word "considered" in 31 U.S.C. § 742 "means taken into account, or included in the accounting" (103 S. Ct. at 3374). The purpose of the apportionment formula is to determine how much income is subject to tax. By including interest on United States obligations in the apportionment formula, such interest is clearly "taken into account, or included in the accounting".

Finally, the Department mischaracterizes the decision of the Supreme Court of Georgia in *Bartow County Bank* v. *Bartow County Board of Tax Assessors, et al.,* 251 Ga. 831, 312 S.E.2d 102 (1984), *prob. juris. noted sub nom. First National Bank of Atlanta, etc.* v. *Bartow County Board of Tax Assessors,* No. 83-1620, 104 S.Ct. 2654 (1984), by attempting to establish a factual identity between that case and the decision below of the Supreme Court of Illinois. However, the facts of the two cases are very different. The *First National Bank of Atlanta* case involves a tax on bank shares based upon net worth and the validity of a formula which is intended to remove Federal obligations from the tax base. In sharp contrast, this case involves an income tax and the Department's attempted inclusion of interest from Federal obligations in the apportionment formula used to calculate the income tax.

Further, the *First National Bank of Atlanta* case appears to conflict with the decision of this Court in *Missouri Ins. Co.* v. *Gehner,* 281 U.S. 313 (1930). In contrast, this case does not conflict with a prior decision of this Court. Continental Bank strongly urges this Court to disregard the Department's attempt to manufacture a conflict between the decision in this case and the *First National Bank of Atlanta* case.

CONCLUSION

For the reasons stated, the Department's Petition for a Writ of Certiorari should be denied.

September 22, 1984

Respectfully submitted,

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